Rotational Investing in Real Estate

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Rotational investing is a time-honored concept in the common equity markets. Investors rotate between styles, value versus growth and between sectors, capital goods, consumer durables, consumer non-cyclicals, financial firms, and other groupings. The belief is that economic conditions favor some sectors over others or one style over the other. Styles also go in and out of fashion. Growth investors dominated the 1990s, while value investors appear to hold sway today. Efficient markets theory would argue that the stock market is so efficient that any pricing anomaly is quickly discovered and eliminated. Perhaps that is true in a perfect world, but events of the past two years give an indication that the rotational concept has validity.

Real estate markets, though increasingly efficient, are a long way from the common equity world in terms of information flows and the birth of expectations. Real estate markets are a perfect arena for rotational investment. They respond to fundamental economics over long cycles, they have widely varying levels of risk, they have different pricing levels, and they too fall prey to fashion. These variables play themselves out slowly over time, giving investors an opportunity to exploit them for gain. Strategies described as "value-added" or "value creation" can be seen as rotational strategies as well.

You are Your Returns

People have viewed real estate investing through many lenses over the years. Currently, the institutional real estate investment business appears to have organized its investment products into three groups: core, value-added, and opportunistic. Those categories tend to be defined by their target returns more than any other characteristic. The risks inherent in different strategies in the value-added or opportunistic categories can vary widely in character and scale. That simple categorization encourages investors to see the risks embedded in each strategy to be equal with other investments in the same category. Adopting a rotational viewpoint leads to a greater insight about the elements of risk. Thus, thinking about real estate investment in a rotational framework may be a more insightful process than merely adopting a "you are your returns" approach.

Table 1: Markets With Total Return Correlation Below 0.40, First Quarter 1991 Through Second Quarter 2002

Market Pair		Correlation Coefficient
Bergen, NJ	Atlanta, GA	0.35
Bergen, NJ	Miami, FL	0.26
Bergen, NJ	Seattle, WA	0.38
Bergen, NJ	Stamford/New Haven, CT	0.34
Bergen, NJ	Tampa, FL	0.34
Denver, CO	Middlesex, NJ	0.37
Detroit, MI	Houston, TX	0.26
Detroit, MI	San Diego, CA	0.38
Detroit, MI	Seattle, WA	0.35
Ft. Lauderdale, FL	San Jose, CA	0.36
Houston, TX	Atlanta, GA	0.29
Houston, TX	Detroit, MI	0.26
Houston, TX	Miami, FL	0.25
Houston, TX	Phoenix, AZ	0.31
Houston, TX	Stamford/New Haven, CT	0.33
Houston, TX	Tampa, FL	0.15
Los Angeles, CA	Miami, FL	0.39
Los Angeles, CA	Middlesex, NJ	0.36
Miami, FL	Middlesex, NJ	0.31
Miami, FL	Orange County, CA	0.35
Miami, FL	Riverside, CA	0.36
Miami, FL	San Diego, CA	0.39
Miami, FL	San Jose, CA	0.33
Miami, FL	Seattle, WA	0.39
Middlesex, NJ	Portland, OR	0.38
Philadelphia, PA	Tampa, FL	0.28
San Francisco, CA	Tampa, FL	0.31
San Jose, CA	Seattle, WA	0.38
San Jose, CA	Stamford/New Haven, CT	0.36
Stamford/New Haven, CT	Tampa. FL	0.38
Stamford/New Haven, CT	Washington, DC	0.36
Tampa, FL	West Palm Beach, FL	0.34

Rotational Real Estate Investing

There are several rotational opportunities available to real estate investors, some that parallel common equity rotations and some that are unique to real estate. Opportunities include rotation in and out of geographic markets, property sectors, and life cycle stages.

Geographic Markets

The idea that regions and cities have differing economic cycles is well- accepted today. The institutional investment experience across markets demonstrates its validity. Table 1 lists market pairs in which the correlation coefficient of total returns from all property types was below 0.40 during the period from the first quarter of 1991 to through the second quarter of 2002, according to the NCREIF return series. In addition to these low coefficient market pairs, three markets have low or negative correlations with all other markets. They are Raleigh, N.C., Las Vegas, Nev., and Jacksonville, Fla. Those three markets also have low or negative correlation with each other. Local and regional economic cycles take some years to go from peak to trough and back again. The presence of these low correlations suggests that there are always markets in different stages of expansion or contraction and thus opportunities to practice a geographic rotation.

Today's intense focus on the market conditions in northern California is evidence of the regional economic cycle writ large. More subdued cycles exist around the country, typically driven by fundamental or exogenous factors. The size of the youth cohort in the mountain states has a positive influence on housing demand relative to the rest of the country. It also has a positive influence on the pace of development. Instability in Latin America brings flight capital into Miami and other markets, and prosperity in Latin America brings tourists and shoppers into the same market. Tourism demand in Hawaii is dependent almost entirely on two feeder markets, California and Japan. When either of those markets is weak, Hawaii feels the effect.

On the positive side, the combination of demographics and regional specialization brought long economic expansions to Boston and New York as household wealth grew along with aging baby boomers and funds flowed into stocks and mutual funds.

Table 2 shows divisional correlation for total return for all property types in NCREIF for the period 1987 through 2001. Although these correlations are generally higher than MSA correlations, we find that the Southwest and Mideast, Southwest and East North Central have coefficients below 0.5 while and the Northeast and the Southwest have a coefficients of only 0.53. Low correlation between regions and divisions also suggests that geographic rotation has a place in investment strategy.

Property Sectors

Investors periodically shift their attention from one property sector to another in reaction to economic fundamentals, capital market swings, or other influences. It is possible to look at the history of the NCREIF return series and make a judgement about the long-run risk and return characteristics of the property sectors. Figure 1 shows the average quarterly total return and standard deviation by property type for the period fourth quarter of 1978 through the second quarter of 2002. If one were a holder in perpetuity, apartments might appear to be the best bet

Table 2: NCREIF Divisional Returns All Property Types: 1987 Through 2001

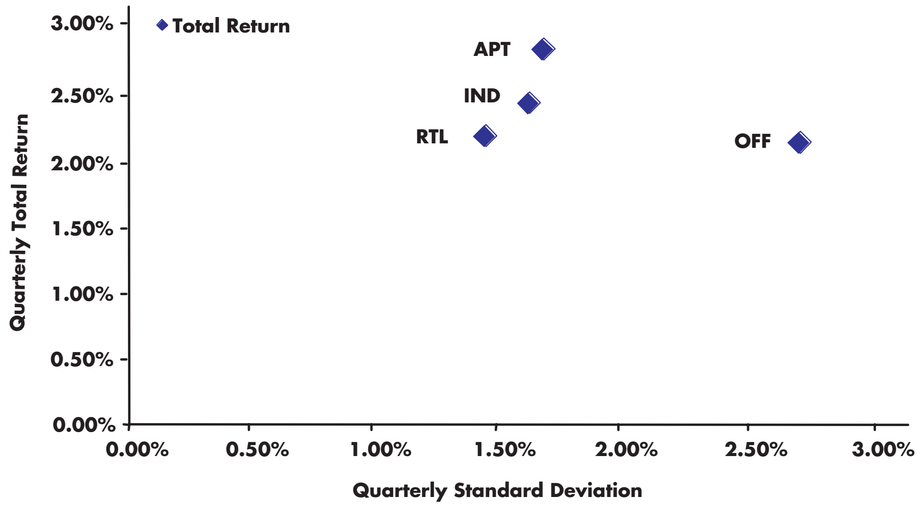
	Northeast	Mideast	East North Central	West North Central	Southeast	Southwest	Mountain	Pacific
Northeast	1.00							
Mideast	0.96	1.00						
East North Central	0.96	0.94	1.00					
West North Central	0.90	0.90	0.88	1.00				
Southeast	0.92	0.89	0.89	0.97	1.00			
Southwest	0.53	0.43	0.49	0.64	0.58	1.00		
Mountain	0.76	0.73	0.71	0.89	0.86	0.75	1.00	
Pacific	0.89	0.87	0.88	0.81	0.78	0.61	0.71	1.00

for the long run since they have posted the highest returns and have shown a moderate level of risk.

But at any given time, do these relationships hold? Can the investor rotate in and out of property types to gain an advantage? There are practical considerations to be sure, not the least of which are the time and effort it takes to place funds and the costs associated with frequent trading. Figure 2 shows the relative rank of each property type by color as well as the annualized returns for a series of five-year holding periods. We can see in Figure 2 that in the five discrete periods since 1978, the highest returns accrued to office properties (blue) between 1978 and 1982. In the next two five-year periods, retail properties (yellow) had the highest return. Between 1993 and 1997, hotels (brown) returned 17.2 percent versus apartments' 11.4 percent total return. In the four-year period between 1998 and 2001, office properties again led the pack. Note also that apartments (green) never took the top spot, but held second place for 20 of the 24 years shown.

What about the ability of investors to spot the inflection points in the market? It is easy to use hindsight to say when you should have been in each sector. The real test of a rotational strategy is to prove that these periods of superior relative performance last long enough for investors to

Figure 1: NCREIF Total Return by Type: First Quarter 1978 to Second Quarter 2002



Source: *NCREIF; Cornerstone*

Figure 2: NCREIF All Property Types Discrete Five-Year Regimes (Annualized Returns)

	1978-82	1983-87	1988-92	1993-97	1998-01*
NPI	19.3%	14.0%	5.6%	17.2%	13.0%
Apartment	19.2%	11.4%	5.0%	11.4%	12.7%
Office	16.1%	11.4%	2.3%	9.6%	12.0%
Industrial	15.3%	10.9%	1.8%	7.8%	11.8%
Retail	10.6%	8.7%	1.7%	7.4%	9.2%
Hotel	4.1%	5.1%	-2.3%	5.6%	8.0%

*Source: NCREIF, Cornerstone * 4 Year Regime* successfully execute the strategy. Figure 3 shows another version of a five-year investment period. In the case shown in Figure 3, the colored blocks represent rolling five-year holding periods, each ending in the year shown. For example, an investor could have gone into apartments (green) in 1978 and sold in 1982, having achieved a five-year annual return of 19.2 percent, only 10 basis points below number one office. But the investor had a six-year window because the rolling five-year regime ending in 1983 delivered a 19.6 percent annual return to apartment investors. In the late 1980s, retail (yellow) began to dominate the return picture. A series of rolling five five-year regimes gave retail investors ten years (1983 through 1992) on top. Surely an institutional investor can execute a strategy within that time frame.

A striking feature of the display in Figure 3 is the persistence of dominance for multiple five-year periods. Of the twenty 20 rolling five-year periods, only three saw a change in dominance at the end of a period. For the period 1992 through 2000, hotels (brown) held top position despite rising returns in other property types. If that persistence recurs in the future, practicing sector rotation in real estate should be an achievable goal, just as common equity managers do over a much shorter horizon.

Life Cycle Stages

Development

Investors can also choose to invest in a specific stage of the property life cycle. The stages are shown in Figure 4 (on page 66). Investment in each stage is often proposed as a strategy, but it is more appropriate to see each position in the life cycle as a response to capital and property market conditions. In a property market with significant barriers to entry, development is an appropriate response because existing properties typically sell at a premium to their development

Figure 3: NCREIF All Property Types Plotting Five-Year Regimes

	1978-82	1983	1984	1985	1986	1987	1988	1989	1990
NPI	19.3%	19.6%	16.1%	14.6%	13.2%	14.0%	14.2%	13.4%	11.6%
Apartment	19.2%	17.5%	16.0%	13.1%	12.9%	11.4%	10.8%	9.9%	7.8%
Office	16.1%	15.5%	14.2%	12.8%	11.4%	11.4%	10.2%	9.0%	7.8%
Industrial	15.3%	15.0%	13.9%	12.8%	11.2%	10.9%	9.8%	8.9%	7.2%
Retail	10.6%	11.2%	12.3%	12.6%	9.9%	8.7%	7.4%	5.8%	3.7%
Hotel	4.1%	6.1%	7.8%	8.5%	6.0%	5.1%	3.8%	1.9%	2.1%

1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
8.6%	5.6%	4.7%	5.3%	6.4%	10.6%	17.2%	19.1%	20.7%	18.8%	13.9%
6.0%	5.0%	3.7%	3.8%	6.1%	9.1%	11.4%	13.0%	14.0%	15.4%	13.3%
5.2%	2.3%	2.4%	2.5%	2.1%	5.4%	9.6%	12.5%	13.8%	14.2%	12.2%
4.3%	1.8%	0.2%	0.0%	2.0%	4.1%	7.8%	12.3%	12.4%	12.8%	12.2%
3.3%	1.7%	0.2%	-0.1%	0.9%	3.4%	7.4%	10.8%	11.8%	12.7%	12.1%
0.1%	-2.3%	-4.2%	-4.3%	-2.7%	2.2%	5.6%	7.2%	7.9%	8.7%	9.1%

Source: NCREIF, Cornerstone

cost, rewarding capital for overcoming the barriers. In a pro-growth market with no constraints on development, new properties are commodity items and are priced accordingly. Deploying capital for development in that case is inappropriate since it can only earn a run-of-the-mill rate of return. In that case, capital will not have earned a sufficient risk premium.

Stabilization

The process of stabilization varies across property sectors and may occur more than once during the life of a property. Changes of use from single tenant to multi-tenant, for example, lead to a new process of stabilization. Investors are adding value at this point because they are transitioning the property to a stage where it bears market risk in the same general way that the bulk of the market does.

Maturity

Mature, or core properties have stable cash flows and bear-market risk at the margin as leases roll. They command higher prices to reflect the lower level of specific risk they bear at that point in the life cycle. In a property market with weak barriers to entry and a pro-growth environment, mature properties in the urban core may offer the investor the chance to capture the risk premium associated with a growth market while bearing roughly the same level of risk as a core property in a higher-priced market. As capital market enthusiasm for specific property types waxes and wanes, it may be wise to rotate in and out of stabilized properties. Selling stabilized assets when the spread between return on cost and capitalization rates is the greatest is an example of a rotational strategy. Where should the capital be re-deployed?

Re-Positioning and Re-Development

When stabilized properties command large premia, re-positioning or re-development is a logical response. Capital market enthusiasm for existing properties, high barriers to entry, and the presence of poorly managed or capital-starved assets all contribute to making this type of value-added activity work.

An important distinction between value-added and opportunistic investing is that these types of value-added activities are grounded in a fundamental understanding of the economy and local property markets. The fact that these behaviors rely on keen insight means that the strategy is built upon its own risk management tools. Market insight and the ability to anticipate property market conditions are powerful risk management inputs. Opportunistic investing, by contrast, has a less focused approach and typically seeks disrupted markets or severely impacted assets. A strategy that requires such conditions is ultimately self-limiting. Perhaps the distinction is that value-added activities involve the creation of value and opportunistic investing involves the seeking out of value.

An Example

An astute rotational investor can combine these insights to develop focused investment strategies that are responsive to all the elements of rotation. An example would be the multi-family sector. Fundamental demographic shifts in the U.S. population argue for a rotation into the multi-family sector. The echo boom generation constitutes a rapidly growing cadre of young adults. These people are turning 21, taking jobs, and forming households. More than 80 percent of this age group are renters for some years. Each year between 3.5 million and 4 million people turn 21 and begin their adult lives. That demographic wave will last through 2010. At the same time, the baby boom generation represents between 3.6 million and 4.3 million people turning 50 each year between now and 2023. Those newly mature adults are for the most part homeowners, but some meaningful portion will choose to be renters and many are at the peak of affluence in their lives. The coincidence of those two waves will make demand for new rental housing strong and keep it strong. So a sector rotation into multi-family looks like a good strategy. How can it be implemented?

Apartments are in favor with institutional investors today based on their return history and based on the knowledge that demographics are positive. The result is that apartments are fully priced. According to Real Capital Analytics, the apartment transaction market remained strong through mid-year with generalized declines in cap rates in most regions. At today's cap rates of around 8 percent, existing units command a premium of 125 to 150 basis points over the potential return on the cost of new construction. Thus, a life cycle rotation into development is attractive in order to capture the premium. By structuring joint venture development transactions carefully, investors can transfer much of the development risk to developer partners, leaving market risk to be borne as the means of earning the premium. How, then, can the market risk be ameliorated?

If a development strategy must bear the market risk, the risk can be minimized by focusing on markets that have barriers to entry. In such markets, we typically find three characteristics: occupancies are above the U.S. average, homes are less affordable than elsewhere, and apartments sell at lower cap rates than elsewhere. Those three factors argue for a market rotation into certain markets that reduces the risk of leasing, reduces the potential competition from the single family home market, and increases the reward to capital for bringing new supply. Thus, a relatively simple idea can be focused on rotational opportunities to lower risk and increase return.

Conclusion

By thinking about rotation through the property life cycle, property sector, and local economy in the context of current capital markets, we can develop a finer appreciation of the risks associated with a given level of expected return. Although the market may price a risk premium, an investor must actually manage the risks in order to earn the premium. The rotational model forces the investor to confront the risks at the specific level and to execute the particular investment strategy with a focus on risk management. ■

Figure 4: Life Cycle Stages